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SUBJECT: Mongolia Scen setter for Codel Hagel

¶1. We look forward to hosting you October 7 to 9. Your visit here will continue a stellar year for high-level bilateral engagement. Over the last year, visitors have included: Speaker Hastert and delegation, then Rep. Leach (both in August 2005); Secretary of Defense Rumsfeld (October); the President, First Lady and Secretary of State (November); Secretary of Agriculture Johanns (in July, leading a Presidential Delegation for the 800th anniversary of Mongolia's establishment as a state); and Codel Kolbe in early September. DCM Brian Goldbeck will be the Charge during your visit; Ambassador Minton will not yet have returned from the East Asia and Pacific Chiefs of Mission conference which will be held in Washington next week.

A New Friend

¶2. Next January 27th, we will celebrate the 20th anniversary of the establishment of diplomatic relations. As the recent plethora of visits demonstrates, in the last 16 years Mongolia has become a friend for the U.S. in Northeast Asia. Once the world's second Communist country, Mongolia now looks to us (and, to a lesser extent, Japan, South Korea, Turkey, Germany and others) as "third neighbors." Mongolia sees good relations with us and other third neighbors as a partial antidote to dependency on, or pressure from, its two immediate neighbors, Russia and China. There is a historical antipathy toward China, which ruled Mongolia for two centuries until 1921, and a concern about being economically overwhelmed by the nearby colossus. Feelings about Russia are warmer, with gratitude for Russia's aid in escaping China's clutches and for assistance (they built schools, hospitals, roads, etc.) during the socialist era, but also some bitterness about the sudden withdrawal of Russian aid, which caused tremendous economic hardship in Mongolia in the early 1990s. Both China and Russia are eager to participate in the development of Mongolia's mineral resources. In July, Russian PM Fradkov visited at the head of a 300-plus person business delegation and sought special access to those resources; he was soundly rebuffed. China, as the logical market for Mongolia's coal and other minerals, may be harder to keep completely at arm's length.

¶3. The July 2004 Joint U.S.-Mongolia Presidential statement describes U.S. relations with Mongolia as a "comprehensive partnership" based on common values and shared interests. Mongolia's "strategic" value for the United States is not in the classic security/military sense. Rather, Mongolia serves as an example - and role model - of a relatively smooth and successful transition from authoritarian communism to democracy and a market economy. The fact that Mongolia is undertaking simultaneous political and economic reform and has, over the past 15 years made many of the right choices, made it eligible for MCA funding in 2004. Mongolia became a member of the Communities of Democracies convening group in the last year.

¶4. Our military-military relations with Mongolia are very good, and



based on assisting Mongolia's defense reform and enhanced capacity to provide elite peacekeeping forces. U.S. mil-mil aid has been and will be a key part of that effort. The Global Peace Support Operations Initiative (GPOI)-supported "Khaan Quest-06" multilateral peacekeeping training exercise took place in August, and spotlighted Mongolia's increasing peacekeeping efforts. Mongolia has been a stalwart supporter in the Global War on Terrorism, and has had troops on the ground in Iraq and Afghanistan since 2003. In early October, it will send its 7th rotation of troops (about 100) to Iraq, where Mongolian soldiers provide force protection for the Polish troops in the Multinational Force at Camp Echo. Mongolian soldiers also are guarding the UN war crimes tribunal in Sierra Leone, and Mongolia sent a detachment to the NATO mission in Kosovo last December.

15. Mongolia has placed a Free Trade Agreement (FTA) high on its bilateral wish list. Its argument for this is exclusively political, as a public sign of good bilateral relations and U.S. support. There is minimal two-way trade (bilateral trade is about \$150 million a year), and it is unclear that there would be any significant economic advantages to Mongolia from an FTA. Our response has been to stress that the necessary required groundwork for any FTA is already being worked on through the Trade and Investment Framework Agreement (TIFA) process. The TIFA was signed in July 2004, and we will have the third round of annual talks in Ulaanbaatar early next year. We are far from working through the TIFA checklist, and doing so will require concerted, sustained Mongolian actions. Mongolian officials appear to believe that we should forget such bothersome details, and would just do a political agreement for an FTA. Faster Mongolian action on TIFA items will not only benefit their trade and investment from the United States, but also from all other economic partners. Meanwhile, there is U.S. investment in two leading Mongolian banks and Caterpillar has a flourishing distributor supplying the mining sector. A U.S. firm,

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Peabody, the world's largest coal only mining company, is very interested in coming in as part of a consortium to develop a large coal deposit near the Chinese border. The Mongolians who own the exploration rights to the deposit need to settle on the consortium details, then begin discussions with the government.

Still In Transition  
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16. While Mongolia has come a long way since 1990, its political and economic transitions remain incomplete. Elections have been largely free and fair, and three of the four parliamentary elections since 1992 have resulted in changes of power. But Mongolia has yet to institutionalize democracy and rule of law. Lack of transparency and corruption (particularly conflict of interest) are major problems. Mongolia's National Human Rights Commission, and the UN Special Rapporteur on Torture, have criticized frequent police abuse of suspects and poor prison conditions. The Mongolian People's Revolutionary Party (MPRP), the self-described social democratic successor to the Communist Party, retains major advantages in cohesion and organization over its rivals. That can lead to lopsided results, as in the 2000 parliamentary elections, when the MPRP parlayed 53% of the popular vote against divided opponents into 72 out of 76 seats.

17. Economically, Mongolia faces daunting disadvantages due to its landlocked status, severe continental climate, and a population of 2.8 million sparsely scattered over a territory the size of Alaska. Some 40% of the population now lives in the capital, the result of an influx of poor herders deciding to try their luck in Ulaanbaatar. Another 40% of the population still relies on semi-nomadic herding. Unemployment is high, and there is a high rate of male alcoholism. Economic growth was 10% in 2004, 6% in 2005, and likely will be 6% again this year. However, this growth is largely based on high world mineral prices and increased mining production, and economic gains are ill-distributed. There is a very large shadow economy -- about half the size of the official one. While most of the economy is in private hands, some key industries remain government-owned. Not only are these industries poorly operated and bankrupt, they also distort the market. In practice, early privatization often most



benefited members of the political elite. Privatization efforts have stalled since 2004. Corruption is the biggest business problem mentioned by foreign and domestic businessmen, and public perceptions of rising corruption help fuel resentments caused by growing wealth disparities.

#### Current Government: Unpopular, Rumors

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18. The current government is an often dysfunctional coalition of the MPRP and several tiny political parties. The government was formed in January, after the MPRP withdrew its ministers from the "grand coalition" government with the Democratic Party formed in September 2004, three months after elections had given no single party a majority of seats. The current government's poll numbers are dismal (in the 25% approval range), and Prime Minister Enkhbold did not even make the list of the country's ten most prominent politicians in an April survey. The government's ability to show leadership amid an atmosphere of populism and nationalism (centered on expensive social welfare promises and sentiment over foreigners profiting from Mongolia's mineral resources) is still in doubt. The government is MPRP-led, but includes four of the other six political parties with seats in the State Great Hural (parliament). That inclusiveness is part of its problem, since there is some Cabinet indiscipline attendant to the various ministers positioning their parties with the public for the June 2008 elections. As with its predecessor, rumors about government stability are recurrent, but it seems a sure bet that some form of an MPRP-led government will be in place until 2008.

#### U.S. and Other Foreign Aid

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19. On a per capita basis, Mongolia has received relatively high levels of aid. From 1990-2004, official development assistance to Mongolia from bilateral and multilateral donors was \$2.7 billion, or nearly \$1000 per person. Since 1991, Japan has been the largest bilateral donor. Total USAID assistance to Mongolia from 1991 through 2005 has been about \$150 million, all in grant form. In the early 1990s, USAID assistance was instrumental in staving off collapse of the energy sector following the Russian withdrawal. The current USAID program emphasizes two main themes: sustainable, private sector-led economic growth; and more effective and accountable governance. About two-thirds of the current (2006) USAID budget of \$7.5 million a year promotes economic growth, and focuses on macroeconomic policy reform, energy sector commercialization, financial sector reform, strengthening the cashmere and tourism industries, and providing business development services to small and

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medium enterprises in both rural and urban areas. USAID has had a number of resounding successes in promoting private sector-led economic growth, as most recently evidenced by Parliamentary passage of the most dramatic overhaul of the Mongolian tax system since the Russians left. The other third focuses on judicial sector reform, electoral reform, parliamentary reform, and anti-corruption work. Through USAID support in democracy and governance, every court in the country has been automated, poll watchers in elections have been trained, and the parliament convinced to strengthen its committee system.

110. In most years since 1993, the United States Department of Agriculture has provided food aid to Mongolia under the Food for Progress and 416(b) programs. The monetized proceeds of the food aid (\$3.7 million in 2005) are currently used to support programs bolstering entrepreneurship, herder diversification, better veterinary services, and disaster relief. The Peace Corps celebrates its 15th anniversary in Mongolia this year and it currently has 104 volunteers in country. They are engaged primarily in English teaching and teacher training activities. At the request of the Government of Mongolia, the Peace Corps also has developed programs in the areas of public health and the environment.

#### Millennium Challenge Account Process

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¶11. In a letter dated July 31, 2006, Millennium Challenge Corporation (MCC) CEO Danilovich officially informed the Mongolians that, based on the complexity of the Mongolian proposal and the slow pace of work on the Mongolian side, MCC is "looking at late spring, 2007, as the target date" for a Compact. Danilovich's letter was in response to a July 21 letter from Ambassador Bold complaining about the delay in reaching a Compact. The GOM, which hoped to sign a Compact during 2006 (the 800th anniversary) is disappointed and frustrated at what it perceives as unnecessary delay in reaching a Compact.

¶12. Mongolia was one of the original 16 MCC eligible countries in ¶2004. From the outset, Mongolian officials had unrealistic expectations that hundreds of millions of dollars would soon be disbursed on the basis of sketchy proposals. Many Mongolians also made the unfortunate and mistaken assumption that MCA was a reward for joining the Coalition in Iraq. We have consistently denied this linkage in public and private, but the perception persists.

¶13. On the Mongolian side, progress and process have been hampered by a serious shortage of Western-educated, trained professional and technical capacity, and a propensity by decision makers to seek consensus rather than set priorities and make hard choices. These factors combined to delay submission of a proposal by Mongolia -- until October 2005. These factors continue to slow the process. The proposal submitted was not only complex, but also not well justified or fully fleshed out. MCC began its due diligence in November 2005 and will continue this phase through the end of 2006.

In Closing

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¶14. Eight hundred years after Genghis Khan (or "Chinggis Khaan" to Mongolians), Mongolia is a land justly famous for its hospitality and its beauty. We and the Mongolian Government are pleased that you found time in your schedule for a brief visit, and look forward to your visit.

Minton